



**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT  
OF THE COMMONWEALTH OF PUERTO RICO**

(A Component Unit of the Commonwealth of Puerto Rico)

Basic Financial Statements and Required Supplementary Information

June 30, 2017

(With Independent Auditors' Report Thereon)



KPMG LLP  
American International Plaza  
Suite 1100  
250 Muñoz Rivera Avenue  
San Juan, PR 00918-1819

## **Independent Auditors' Report**

To the Retirement Board of the Government of Puerto Rico  
Employees' Retirement System of  
the Government of the Commonwealth of Puerto Rico:

We have audited the accompanying financial statements of the Employees' Retirement System of the Government of the Commonwealth of Puerto Rico (the System), which comprises the statement of fiduciary net position as of June 30, 2017, the related statement of changes in fiduciary net position for the year then ended, and the related notes to the financial statements, which collectively comprise the System's basic financial statements.

### *Management's Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditors' Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### *Opinion*

In our opinion, the financial statements referred to above present fairly, in all material respects, the fiduciary net position of the Employees' Retirement System of the Government of the Commonwealth of Puerto Rico as of June 30, 2017, and the changes in its fiduciary net position for the year then ended, in accordance with U.S. generally accepted accounting principles.



### *Emphasis of Matters*

#### Uncertainty about Ability to Continue as a Going Concern

The accompanying financial statements have been prepared assuming that the System will continue as a going concern. As discussed in notes 3 and 14 to the basic financial statements, the System is severely underfunded, sold its remaining investments in the aggregate amount of approximately \$297 million, and started operating on a pay as you go basis in fiscal year 2018. Additionally, on May 3, 2017 and May 22, 2017, the Financial Oversight and Management Board commenced cases for the Commonwealth of Puerto Rico and the System, respectively, by filing petitions for relief under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act with the United States District Court for Puerto Rico. Accordingly, management of the System has stated that substantial doubt exists about the System's ability to continue as a going concern. Management's evaluation of the events and conditions and management's plans regarding these matters are also included in note 3. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinion is not modified with respect to this matter.

### *Other Matters*

#### Required Supplementary Information

U.S. generally accepted accounting principles require that the management's discussion and analysis on pages 3–14 and the schedules in pages 75–81 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

**KPMG LLP**

San Juan, Puerto Rico  
June 29, 2020

Stamp No. E403599 of the Puerto Rico  
Society of Certified Public Accountants was  
affixed to the record copy of this report.

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**(j) Other Postemployment Benefits (OPEB) – Healthcare Benefits**

ERS MIPC is an unfunded cost-sharing, multi-employer defined benefit other postemployment benefit plan sponsored by the Commonwealth. ERS MIPC covers a payment of up to \$100 per month to the eligible medical insurance plan selected by the member provided the member retired prior to July 1, 2013 (Act No. 483, as amended by Act No. 3). Substantially all full time employees of the Commonwealth's central government, certain municipalities of Puerto Rico and certain component units of the Commonwealth not having their own postemployment benefit plan, were covered by the OPEB.

Commonwealth employees became members upon their date of employment. Plan members were eligible for benefits upon reaching the pension benefits retirement ages.

At July 1, 2016, the membership consisted of the following:

Membership:	
Retired members	94,071
Disabled members	<u>14,722</u>
Total membership	<u><u>108,793</u></u>

The contribution requirement of ERS MIPC is established by Act No. 95 approved on June 29, 1963. This OPEB plan is financed by the Commonwealth. There is no contribution requirement from the plan member during active employment. Retirees contribute the amount of the healthcare insurance premium not covered by the Commonwealth contribution. As a result, these OPEB are 100% unfunded. During the year ended June 30, 2017, OPEB contributions amounted to \$91 million.

The funding of the OPEB benefits is provided to the System through legislative appropriations each July 1 by the Commonwealth's General Fund for former government and certain public corporations without their own treasuries employees, and by certain public corporations with their own treasuries and municipalities for their former employees. The legislative appropriations are considered estimates of the payments to be made by the System for the healthcare benefits throughout the year.

**(5) Net Pension Liability**

The components of the net pension liability as of June 30, 2017 were as follows (dollars in thousands):

Total pension liability	\$ 30,091,826
Plan's fiduciary net deficit	<u>(2,108,853)</u>
Net pension liability	<u><u>\$ 32,200,679</u></u>
Plan's fiduciary net deficit as a percentage of the total pension liability	(7.01)%

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**(a) Actuarial Methods and Assumptions**

The census data collection date is at the beginning-of-the fiscal year. The liability results as of June 30, 2017 are based on projecting the System obligations determined as of the census data collection date of July 1, 2016 for one year, using roll-forward methods and assuming no liability gains or losses.

The actuarial valuation used the following actuarial assumptions:

Inflation	Not applicable
Municipal bond index	3.58%%, as per Bond Buyer General Obligation 20-Bond Municipal Bond Index
Projected salary increases	3.00% per year. No compensation increases are assumed until July 1, 2021 as a result of Act No. 3-2017 and the current general economy.
Mortality	<p>Pre-retirement Mortality:</p> <p>For general employees not covered under Act No. 127, RP-2014 Employee Mortality Rates for males and females adjusted to reflect Mortality Improvement Scale MP-2017 from the 2006 base year, and projected forward using MP-2017 on generational basis. For members covered under Act No. 127, RP-2014 Employee Mortality Rates with blue collar adjustments for males and females adjusted to reflect Mortality Improvement Scale MP-2017 from the 2006 base year, and projected forward using MP-2017 on generational basis. As generational tables, they reflect mortality improvements both before and after the measurement date.</p> <p>100% of deaths while in active service are assumed to be occupational for members covered under Act No. 127.</p>

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Post-retirement Healthy Mortality:

Rates which vary by gender are assumed for healthy retirees and beneficiaries based on a study of plan's experience from 2007 to 2012 and updated expectations regarding future mortality improvement. The 2010 base rates are equal to 92% of the rates from the UP-1994 Mortality Table for Males and 95% of the rates from the UP-1994 Mortality Table for Females, both projected from 1994 to 2010 using Scale AA. The base rates are projected using Mortality Improvement Scale MP-2017 on a generational basis. As a generational table, it reflects mortality improvements both before and after the measurement date.

Post-retirement Disabled Mortality:

Rates which vary by gender are assumed for disabled retirees based on a study of plan's experience from 2007 to 2012 and updated expectations regarding future mortality improvement. The 2010 base rates are equal to 105% of the rates from the UP-1994 Mortality Table for Males and 115% of the rates from the UP-1994 Mortality Table for Females. The base rates are projected using Mortality Improvement Scale MP-2017 on a generational basis. As a generational table, it reflects mortality improvements both before and after the measurement date.

Most other demographic assumptions used in the June 30, 2017 valuation were based on the results of an actuarial experience 2009 study using data as of June 30, 2003, June 30, 2005 and June 30, 2007.

**(b) Long-Term Expected Rate of Return**

The long-term expected rate of return on pension benefits investments was not applicable as of June 30, 2017. Net assets are negative as of June 30, 2017 and accordingly, it is not possible to determine a rate of return on net assets during the fiscal year. In addition, after June 30, 2017, due to the PayGo system by which the Commonwealth guarantees payment of pensions. System assets were no longer necessary to generate investment returns to pay pension benefits. The approximate actual rate of return on gross assets was 8.74% as of June 30, 2017.

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Before June 30, 2017, the pension plan's policy for allocation of invested assets has been established and may be amended by the System's Board of Trustees. Plan assets are managed on a total return basis with a long-term objective of achieving and maintaining a positive impact on the System's financial condition for the benefits provided through the pension programs. The following asset allocation policy as of June 30, 2017 was adopted by the System's Board of Trustees:

	<u>Target allocation</u>	<u>Long-term expected rate of return</u>
Asset class:		
Domestic equity	56 %	N/A
International equity	15	N/A
Fixed income	28	N/A
Cash	1	N/A
	<hr/>	
Total	100 %	
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In prior years, the long-term expected rate of return on pension benefits investments was determined using a building-block method in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. These ranges are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. This year, the long-term expected rate of return assumption is no longer applicable.

**(c) Discount Rate**

The asset basis for the date of depletion projection is the System's fiduciary net position (the gross assets plus deferred outflows of resources less the gross liabilities, including the senior pension funding bonds payable, plus deferred inflows of resources). On this basis, the System's fiduciary net position was exhausted in the fiscal year 2015.

The System's fiduciary net position was not projected to be available to make all projected future benefit payments of current active and inactive employees. Therefore, the tax free municipal bond index (Bond Buyer General Obligation 20-Bond Municipal Bond Index) was applied to all periods of projected benefits payments to determine the total pension liability. The discount rate was 3.58% as of June 30, 2017.

The June 30, 2017, actuarial valuation reflects a decrease of \$5,498 million in the net pension liability, mainly related to changes in assumptions of \$4,179 million, as a result of an increase in the discount rate as required by GASB Statement No. 67 from 2.85% in fiscal year 2016 to 3.58% in fiscal year 2017, and the effect of plan changes of approximately \$2,017 million.

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**(d) Sensitivity of the Net Pension Liability to Changes in the Discount Rate**

The following presents the net pension liability calculated using the discount rate of 3.58%, as well as what it would be if it were calculated using a discount rate of 1%-point lower (2.58%) or 1% point higher (4.58%) than the current rate (dollars in thousands):

	<b>1% Decrease (2.58%)</b>	<b>Current discount rate (3.58%)</b>	<b>1% Increase (4.58%)</b>
Net pension liability	\$ 36,599,444	32,200,679	28,666,953

**(6) Cash and Cash Equivalents, Investments and Securities Lending Transactions**

*Cash and Cash Equivalents*

Cash and cash equivalents as of June 30, 2017 consisted of the following (in thousands):

	<b>Carrying amount</b>	<b>Depository bank balance</b>	<b>Amount uninsured and uncollateralized</b>
Deposits with GDB	\$ —	30,027	30,027
Deposits with Puerto Rico commercial banks	460,174	454,587	—
Money market funds	15,619	N/A	N/A
U.S. Treasury bills	909	N/A	N/A
Total	\$ 476,702	484,614	30,027

Custodial credit risk for deposits is the risk that, in an event of the failure of a depository financial institution, the System may not be able to recover deposits or collateral securities that are in the possession of an outside party. The Commonwealth requires that public funds deposited in Puerto Rico commercial banks be fully collateralized for the amount deposited in excess of federal depository insurance. All securities pledged as collateral are held by banks in the Commonwealth's name. Deposits with GDB and with non-Puerto Rico commercial banks and money market funds are uninsured and uncollateralized, as these entities are exempt from compliance with the collateralization requirement.

Restricted cash and cash equivalent amounted to approximately \$216 million as of June 30, 2017 and consisted of the following:

- Approximately \$1.9 million of funds are restricted for the debt service of the bonds payable, and 100% of such funds were deposited at trustee in money market funds